

III.C.1. Schedule M Analysis

Introduction There are significant differences in the accounting treatment of items for book and tax purposes. While many of these differences reflect legitimate distinctions between GAAP and tax accounting, some may be simply sham transactions having tax avoidance as their sole objective.

Audit Steps The following are suggested audit steps for examining Schedule M-1:

Step	Action
1	Request the work papers and supporting documents used to prepare the tax return, and reconcile the book income shown on line 1 of the Schedule M-1 to the actual net profit or loss.
2	Reconcile the federal income tax on line 2 of the Schedule M-1 to the amount reported on the books. (This amount includes current and deferred taxes).
3	Secure a comparative analysis of each Schedule M-1 adjustment, comparing the current year(s) Schedule M-1 to the prior and subsequent years' Schedule M-1.
4	Prepare work papers to verify the propriety and accuracy of all Schedule M-1 adjustments.
5	Secure all pertinent documentation to substantiate the computation of the entries including: <ul style="list-style-type: none">• Books of original entry• Audited financial statements• Audit work papers or schedules• Source documents such as invoices, contracts, and agreements.
6	Review book balance sheet and book profit and loss accounts for possible omissions from Schedule M-1 increases to income.
7	Develop a list of excepted items to be included on Schedule M-1. Ask the taxpayer to explain the accounting treatment for such items, for book and tax purposes, if the excepted items are not listed on Schedule M-1.

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Mechanical Errors

The entries on Schedule M-1 are not part of the taxpayer's double-entry accounting system. The normal accounting controls do not exist and consequently, errors are frequent. An item may be deducted on the books and then deducted again erroneously on Schedule M-1. Many times, numbers will be transposed resulting in an erroneous adjustment. Seemingly innocent adjustments have yielded large audit issues.

Book Expenses not on the Return

It is important to investigate expenses not deducted on the return. An expense per books but not on the return could result in an incorrect amount on the Schedule M-1. For example, a \$5,000 amount on line 4 or 5 may in fact be \$500,000. Review the accounts and account numbers to determine if the taxpayer handled them correctly.

Netting Items

The taxpayer may disguise its Schedule M-1 adjustment by combining or netting items, which would normally be reported as separate line items. Although there may not be an adjustment to income, netting distorts a realistic analysis of the Schedule M-1. Separately, an item may stand out as an improper item.

Excepted Schedule M-1 Adjustments

It is not possible to list every excepted item that would appear on Schedule M-1. However, you should develop a list of excepted Schedule M-1 adjustments in your taxpayer's industry. Technical Advisors may be able to provide assistance in this area.

Omitted Items

Omitted Schedule M-1 items can be found by investigating balance sheet accounts (especially liabilities), which are not affected by Schedule M-1 adjustments on the tax return. Based on the titles to these accounts and other information developed in the audit, determine if a book and tax difference exists. The taxpayer often misses new general ledger accounts that should be included in M-1 adjustments.

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Coordinated Issues Determine if your taxpayer is subject to coordinated issues or other issues under the jurisdiction of a Technical Advisor. Ensure that the taxpayer has properly made Schedule M-1 adjustments for the excepted coordinated issues.

FASB's There are numerous Financial Accounting Standards Board (FASB) statements, which result in Schedule M-1 adjustments.

Consistency For examinations involving a consolidated return or examination of separate returns in the same industry, you should compare similar Schedule M-1 entries and similar trial balance accounts among the various companies.

Adjusting Journal Entries Understanding adjusting journal entries (AJEs) and reclassification entries is a vital part of examining a taxpayer's books and may lead to Schedule M-1 adjustments. The following example shows how.

Example Examiners should look for Schedule M-1 entries that were computed by reference to incorrect account balances. This can occur when the Schedule M-1 entry was computed using book account balances believed to be accurate but later altered by year-end adjusting journal entries. Additionally, look for Schedule M-1 entries computed by reference to book account balances that included adjusting entries not applicable to the year under examination.

Review of Liability and Expense Accounts Your audit plan should always include a review of the reserve account and corresponding expense account. Improper debits or credits in these accounts may have an impact on the change that is used to compute the M-1 adjustment.
